IN THE HIGH COURT OF GUJARAT AT AHMEDABAD

INCOME TAX REFERENCE No 318 of 1984

For Approval and Signature:

Hon'ble MR.JUSTICE R.K.ABICHANDANI
and
Hon'ble MR.JUSTICE A.R.DAVE

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1. Whether Reporters of Local Papers may be allowed to see the judgements? : YES

2. To be referred to the Reporter or not? : YES

3. Whether Their Lordships wish to see the fair copy of the judgement? : NO

4. Whether this case involves a substantial question of law as to the interpretation of the Constitution of India, 1950 of any Order made thereunder? : NO

5. Whether it is to be circulated to the Civil Judge? : NO

COMMISSIONER OF INCOME TAX

Versus

KAIRA DIST CO-OP MILK PRODUCERS' UNION LTD.

Appearance:

MR B.B.NAIK for MR MANISH R BHATT for Petitioner

MR JP SHAH with MR MANISH J. SHAH for Respondent No. 1

CORAM : MR.JUSTICE R.K.ABICHANDANI
and
MR.JUSTICE A.R.DAVE

Date of decision: 11/07/2000

ORAL JUDGEMENT (Per R.K.Abichandani,J.)

The Income Tax Appellate Tribunal, Ahmedabad

Bench "C" has referred the following three questions for the opinion of this Court under Section 256(1) of the Income Tax Act, 1961.

1. "Whether the assessee's claim for deduction in respect of contribution to Gujarat Rajya Co-operative Education Fund, was allowable?"

2. "Whether the Tribunal is right in confirming the decision of the CIT (Appeals) allowing the depreciation on road?"

3. "Whether on the facts and in the circumstances of the case, the appellate Tribunal was right in law in holding that cost price of milk powder and soya flour received by the Union from the UNICEF free of charge is not deductible in computation of total income?"

2. The relevant Assessment Years are 1976-777, 1977-78 and 1978-79. The assessee is a Co-operative Society engaged in the marketing of milk and milk products. It had claimed for deduction, the contribution to Gujarat Rajya Co-operative Education Fund. The Tribunal held that the assessee's said claim, which is covered by the above question No.1 was allowable and confirmed the order of the CIT (Appeals). It is pointed out that this question stands answered by a decision of this Court in Mehsana District Co-operative Milk Producers Union Ltd. Vs. CIT, reported in 203 ITR 601, in which it was held that as the assessee had to contribute to the Education Fund since it declared a dividend of 3% or more, the contribution made to the Education fund was deductible. This decision was followed in the assessee's own case in CIT Vs. Kheda Co-operative Milk Producers's Union Ltd., reported in 209 ITR 898, in which it was held by this Court that the contribution to the Gujarat Co-operative Education Fund by the assessee was allowable as business expenditure. In view of the ratio of these decisions, question No.1 stands concluded and is answered against the Revenue and in favour of the assessee.

3. The assessee had claimed depreciation in respect road and the Tribunal confirmed the decision of the CIT (Appeals) allowing such depreciation. It was pointed out by the learned Counsel that even this question is covered by the decision of this Court in assessee's own case, namely - Kaira District Co-operative Milk Producers' Union Ltd. Vs. CIT, reported in 162 ITR 496, in which it was held that the assessee was entitled to

depreciation in respect of road under Section 32 of the Act, as building. Again in assessee's own case in CIT Vs. Kaira District Co-operative Milk Producers' Union Ltd., reported in 192 ITR 608, it was held by this Court that the written down value of the approach road has to be worked out by treating it as building. The Supreme Court in CIT Vs. Gwalior Rayon Silk Manufacturing Co.Ltd., reported in 196 ITR 149, held that the roads laid within factory premises as links or providing approach to the buildings to carry on the business activity of the assessee are "buildings" within the meaning of Section 32 of the said Act. In this view of the matter, question No.2 is answered in the affirmative against the Revenue and in favour of the assessee.

4. The next question that is propounded for our decision is, whether the value of the raw-material said to have been received without payment by the assessee through the Government from the UNICEF was deductible as cost in the computation of its total income.

5. The learned Counsel for the Revenue contended that since there was no expenditure incurred by the assessee in acquiring the raw-material for the purpose of its business within the meaning of Section 37 of the said Act, it cannot be allowed in computing the income chargeable under the head "profits and gains of business or profession". According to him, the cost of such material was not paid by the assessee and hence, its expenditure should be taken as "nil". It was argued by the learned Counsel for the Revenue that since the profit margin of the assessee fixed under the agreement was upto 10 per cent of the cost of production, the assessee could not have charged anything more than the cost actually incurred for production and 10 per cent thereof without taking into account the value of the raw-material, which was received free of cost by the assessee under the Scheme. The learned Counsel in support of his submissions, relied upon the following decisions:-

(a) Reference was made to Mehsana District Co-operative Milk Producers' Union Ltd. Vs. CIT, reported in 203 ITR 601, in which the question of loan given by the Government for setting up milk drying plant was involved and it was held that if any expenditure was wholly or exclusively incurred by an assessee with a view to preserving and augmenting its prospects in future, such expenditure would be allowable expenditure under Section 37 of the said Act. It

was held that the loan was given for the purpose of setting up milk drying plant and it would not mean that loan was given for purchasing of plant and machinery only and that this aspect was not considered by the Tribunal. The Tribunal had to find out, as a result of conversion of part of the loan into subsidy, what should be regarded as written down value of the asset for computing depreciation.

(b) Ravi Leathers (P.) Ltd. Vs. Commissioner of Income Tax, reported in 240 ITR 702 was cited on the construction of the provision of Section 43(1) of the said Act. In that case the assessee claimed that it had been granted a loan free of interest by a foreign company and subsequently the foreign company expressed its desire to treat the amount as a total grant to the assessee for the purchase of machinery and that the assessee therefore need not repay the amount. The assessee claimed before the ITO that the amount received was a capital receipt, which contention was negated. The CIT (Appeals) held that the amount given to the assessee by way of grant was a capital receipt. Before the Tribunal it was contended that even if the grant were held to be a capital receipt, it would go to reduce the actual cost of the machinery purchased by the assessee. The Madras High Court observed that originally the amount was given by the foreign buyers as interest-free loan for the purchase of machinery and subsequently, it was converted as a gift by the foreign buyers to the assessee. It was not a case where the foreign party acquired machinery and then gifted to the assessee, but was a case where the assessee purchased the machinery and the contribution had been provided by the foreign buyer. Section 43(1) and Explanation 2 to that Section dealt with two different concepts. Clause (1) of Section 43 dealt with a case of an assessee purchasing a machinery and the portion of the actual cost of the machinery was met by a third party, while Explanation 2 to Section 43(1) dealt with a case where the asset was purchased by a third party and later on gifted to the assessee. The Court held that the case of the assessee did not fall within Explanation 2 to Section 43(1) of the Act, as the machinery was purchased by the assessee itself and it fell within the purview of clause (1) of Section 43 of the Act and the actual cost

had to be determined in the manner provided in Section 43(1) of the Act.

6. The learned Counsel for the assessee on the other hand contended that the cost of such raw-material was required to be reflected when it was put in business by the assessee even if the raw-material was acquired free of cost. In support of his contention, the learned Counsel relied upon the following decisions:-

(a) The decision of the Madras High Court in CIT, Madras Vs. A.V. Appu Chettiar, reported in 45 ITR 152 was cited for the proposition that stock-in-trade obtained under an inheritance was a property of the legatee if the legatee puts it in the business thereafter, he would be putting his property in the business and the opening stock was required to be valued at its real value on the date of the death of the testator and that was its market value.

(b) Decision in Badridas Daga Vs. CIT, reported in 34 ITR 10 was cited for the proposition that while Section 10(1) of the Indian Income Tax Act, 1922 imposed a charge on the profits or gains of a business, it did not provide how these profits were to be computed and that profits and gains which are liable to be taxed under Section 10(1) are what are understood to be such under ordinary commercial principles. It was held that claim for deduction arising out of carrying on business and incidental to it will be admissible on accepted commercial practice and trading principles.

(c) Decision of the Supreme Court in CIT Vs. Bai Shrinbai K. Kooka, reported in 46 ITR 86 was referred to for the proposition that the assessable profits on the sale of the shares was the difference between the sale price of the shares and the market price of shares prevailing on the date when the shares were converted into stock-in-trade of the business in shares, and not the difference between the sale price and the price at which the shares were originally purchased by the assessee.

(d) Decision in Kalooram Govindram Vs. CIT, reported

in 57 ITR 335 (S.C), was cited for the proposition that if the valuation of the property for the purpose of partition was not notional but was real and that was the basis for allocating properties to different members, the cost of a property allotted to member cannot be that at which it was purchased by the joint family in the remote past, but would be the value given to it for the purpose of allotment or at which it was auctioned for the purpose of partition.

(e) Decision in CIT Vs. Groz-Beckert Saboo Ltd., reported in 116 ITR 125 (S.C), was cited to point out that in a case where the raw-material and semi finished goods were received by the assessee as capital assets and subsequently were transferred to the business as a part of its stock, the cost of the raw-materials and the semi-finished goods could not be said to be nil and that the amount was rightly debited to the Trading Account, and was liable to be deducted in determining the profit from the sale of the finished products. The Supreme Court held that it was well settled that where an assessee converts his capital assets into stock-in-trade and starts dealing in them, the taxable profit on the sale must be determined by deducting from the sale proceeds the market value at the date of their conversion into stock-in-trade (since this would be the cost to the business) and not the original cost to the assessee.

(f) Decision in Anil Starch Products Ltd. Vs. CIT, reported in 59 ITR 514 (Guj.), was cited to point out that it was held in context of the provisions of Section 15C of the Act of 1922 that the profits of a new undertaking would have to be computed on ordinary commercial principles i.e. on realistic value of the business assets transferred from one activity to the another.

(g) Decision in CIT Vs. Ashwin M. Patel, reported in 144 ITR 566 (Guj.), which relied upon the decision in A.V Appu Chettiar's case (supra), was referred to for the proposition that where shares were thrown by the karta of an HUF into the family hotchpot, the cost of acquisition of the shares to the HUF, for the purpose of computing capital gains arising from the sale of those shares by the HUF, would be the market value of the shares as on the date on which it acquired

them, namely, the date on which they were thrown into the common hotchpot by the karta.

7. As provided by Section 145(1) of the said Act, income chargeable under the head "Profits and gains of business or profession" shall be computed in accordance with the method of accounting regularly employed by the assessee. As held by the Supreme Court in Investment Ltd. Vs. CIT, reported in 77 ITR 533, 538, valuation of closing stock must be deemed to be part of method of accounting. It is well settled that the valuation to be adopted when stock is purchased is its actual price paid by the assessee whether in cash or in kind [see Osborne V Steel Barrel Co.Ltd. (1942) 24 Tax Cases 293 & Craddock V Zevo Finance Co. Ltd. (1946) 27 Tax Cases 267]. But what should be done when the stock is not purchased but received by way of a grant or a gift is the moot controversy here.

8. In the present case, during the assessment period relevant i.e. A.Y 1976-77, the assessee received without payment Soya flour and skimmed milk powder of the value of Rs. 13,03,192 being the raw-material for manufacturing high protein food. Consumption of Soya flour and skimmed milk powder being raw material were debited to profits and loss account and sales of high protein food credited to it by the assessee. The said raw-material was received by the assessee under an agreement dated 21.4.1970 with the Government of India, under which the Government of India undertook to arrange for the raw-material under the aegis of the UNICEF. The Government of India also agreed to arrange for supply of spare parts for the plant and machinery from the UNICEF, which item is the subject matter of similar controversy for the assessment year 1977-78. As against the supply of the raw-material free of cost from the UNICEF, the assessee undertook to the Government a corresponding obligation under the agreement to supply free of cost to the Government, as a matching contribution, a specified quantity of weaning food at a price not exceeding 10% profit over the cost of production. This matching commitment of the assessee was to start after 24 months of the installation of the machinery and equipment. The supply of the matching contribution was to be in a phased manner to be determined by the Government. The entire value of the raw material of Rs. 13,93,192 was debited by the assessee in the trading account and credited to the stores account. The ITO held that charging of the amount to the trading account was not justified because

the raw material was received free of cost and that there was no liability on the assessee to meet the expenditure during the previous year itself. The CIT (Appeals) reinforced the order of the ITO by holding that the receipt of the raw material was intimately connected with the assessee's business and was on revenue account and that it would also be assessee's income under Section 2(24) read with Section 28(iv) as benefit arising from the assessee's business. The Tribunal holding that the raw-material was received on revenue account, distinguished the decision of the Supreme Court in CIT Vs. Groz-Beckert Saboo Ltd. (supra) on the basis of which the assessee had claimed the deduction of the cost price of the raw material.

9. In the context of accounting issues relating to government grants, the term "Government" has a broader meaning than its usage in the common parlance and refers to Government, Government agencies and similarly bodies whether local, national or international. [See IAS-20 "Accounting for Government Grants and Disclosure of Government Assistance" issued by International Accounting Standards Committee (IASC) and also Accounting Standard (AS) 12 issued by the Council of Institute of Chartered Accountants of India (ICAI)] on "Accounting for Government Grants".

9.1 The Government grants are assistance by the Government in the form of transfer of resources to an enterprise in return for past or future compliance with certain conditions relating to the operational activities of the enterprise. Such grants can be classified either as capital or revenue receipts depending on their nature. Where the grant is with reference to total investments or capital outlay of the entity and the incentives are without any matching cost, it would be inappropriate to recognise it in profit and loss account and capital approach would be favoured. However, where the grant is coupled with a liability to a matching contribution, its acceptance by itself creates a liability to incur the matching cost. In such a case, conditions to be fulfilled to avail of a grant will be its cost and it cannot be said that there is any benefit given free of cost by way of a gift. In fact to call a grant based on a liability, a gift will be a misnomer because the essence of a gift is that it is a gratuitous transfer. Gifts are always gratuitous, while grants are upon some consideration or equivalent. Grants may become refundable because of non-fulfilment of the conditions attached to such grant. In the present case, the supply of raw-material and spares on the condition that the

assessee will supply protein food over a period of time limiting its profit to 10% of the production cost was therefore a conditional grant in lieu of the liability undertaken by the assessee and not a gift properly so-called.

10. When a non-monetary grant in form of supply of raw-materials, as in the present case, is charged to the income statement at a "nominal" or "nil" rate, it would lead to present a superior profit figure without indicating as to how much of such profit results from such grant. This would mislead the appreciation of profitability of the reporting entity in absence of the grant. Similarly, when asset is supplied free of cost and it is recorded at a nominal or `nil' value, it will have the effect of understatement of asset position and the real strength of the reporting entity would not be correctly appreciated. Thus, opting out from fair value accounting would lead to non-transparent reporting. Therefore, inputs received at a concessional rate or free of cost should be charged at their fair value.

11. The raw-material and spares supplied to the assessee were not a gift properly so-called in view of the conditions which were attached to such supply under an elaborate agreement between the Government and the assessee, which fixed the maximum return at 10% of the cost of production which obviously would include the cost of the raw-material used for the end product. The undertaking of the liability under these terms was, in law, the price which the assessee paid for the raw-material. The worth of raw-material was already indicated in the agreement to tie down the assessee for a matching contribution on the basis of that value and that value obviously could be treated as the cost of raw-material. The scheme was a welfare measure and therefore, restrictive of the assessee's profit margin. Every transaction when analysed has two aspects, an aspect of giving, and an aspect of receiving. One who receives is a debtor and one who gives is a creditor. Under the double entry system both these aspects receiving and giving are recorded in terms of account. The account which receives the benefit is debited. Goods when received are coming in business and that transaction is to be expressed or measured in terms of money in the account that receives the benefit. Therefore, the assessee rightly debited the value of the raw-material of Rs. 13,93,192 and the value of consumable stores Rs. 1,87,154 in the two relevant previous years in the trading account and credited the same to the stores account. It therefore cannot be validly contended by the

Revenue that the charging of the said amounts to the trading account by the assessee was not justified.

12. Even if the supply of raw-materials were to be treated as a gift to the assessee, it cannot be said that where such raw-material is put in stock-in-trade, it should be valued at "nil" cost. Cost of a thing would be the sum of money it will be obtainable for. In the hands of the donee the gifted material has its value and he is the owner of that property even if no cost was incurred by him for acquiring it. He is free to put the goods received by way of gift into his business or purchase similar goods and put them in the business. In the later case his income will be the sale proceeds minus the cost of material while in the former, if the stock is not valued, it will be sale proceeds minus `nil' cost, which means the entire sale proceeds will become taxable including the value of the stock-in-trade put in the business. The entire sale proceeds or receipts would be treated as profits and made liable to tax which "would make no sense" as held in Shirinbai Kooka's case (supra) by the Supreme Court. In Osborne V Steel Barrel Co.Ltd., (1942) 24 Tax Cases 293, Lord Greene M.R reading the judgement of the Court of Appeal described the argument on behalf of the Crown, that if a company acquired stock in consideration of the issue of fully paid shares to the vendor that stock must, for the purpose of ascertaining the company's profits, be treated as having been acquired for nothing, with the result that when it comes to be sold the Revenue is entitled to treat the whole of the purchase price obtained on the sale as profit, as a remarkable contention really resting on a misconception. In Groz-Beckert Saboo Ltd. (supra) the Supreme Court following decision in Shirinbai Kooka's case, which was followed in CIT Vs. Hantapara Tea Co. Ltd. (89 ITR 258 (S.C), has put the matter beyond any pale of doubt by holding that it was well settled by these decisions that where an assessee converts his capital asset into a stock-in-trade and starts dealing in them, the taxable profit on the sale must be determined by deducting from the sale proceeds the market value at the date of their conversion into stock-in-trade, since this would be the cost to the business and not the original cost to the assessee. In that case the original cost of the raw-material and semi-finished needles sent free of cost by assessee's German collaborators was "nil", but they were introduced in the business and converted into stock-in-trade and the Supreme Court held that their market value as on the date of such conversion would represent their cost to the business and that would have to be taken into account in determining the profit

arising from the sale of manufactured products. This was a very apposite binding precedent to be followed but somehow the Tribunal noticed it differently.

13. In the context of what we are considering, it will be appropriate to refer to the definition of "actual cost" in Section 43(1) of the Act as it stood in the relevant years, for the purpose of Sections 28 to 41, wherein under explanation 2 it was provided that where an asset was acquired by the assessee by way of gift or inheritance, the actual cost of the asset to the assessee shall be the written down value thereof as in the case of the previous owner for the previous year in which the asset is so acquired or the market value thereof on the date of such acquisition, whichever is less. It will be seen that this has been said in the explanation No.2 not to create any deeming fiction but to explain the meaning of the words actual cost, which may be obvious in the field of accounting practices, but required to be explained, ex-abundanti cautela, to the legal field to allay groundless apprehensions. It is significant to note that the definition of "actual cost" and other terms in Section 43 is given for defining "certain terms relevant to income from profits and gains of business or profession", as stated in the title of Section 43. The words "actual cost" are relevant to income from profits and gains from business. In Section 29 of the Act it is laid down that the income referred to in Section 28 chargeable under the head "Profits and gains of business or profession", shall be computed in accordance with the provisions contained in Sections 30 to 43A of the Act. Therefore, even for the purpose of computing income under the head "Profits and gains of business or profession" under Section 28, the definition of `actual cost' in Section 43 would be relevant. It would therefore, not be correct to contend that the words "actual cost" as defined would apply only in a few provisions in which they are occurring. In the context of the provisions of Sections 43 and 29, the meaning of actual cost, unless the text otherwise required, is clearly applicable to that expression in so far as it is relevant to computing the income chargeable under the head "profits and gains of business or profession". Explanation 2 to Sec. 43(1) therefore provides a strong reason for showing the value of the goods received by way of gift and put in business measured terms of money while computing the income under Section 28 of the Act.

14. In view of the above discussion, there is no basis for accepting "nil" cost concept, as propounded on behalf of the Department, that would fly in the face of

the accounting practices as well as the settled legal position reflected in the above decisions of the apex Court. We therefore hold that the Tribunal committed an error in holding that the cost price of milk powder and soya flour received by the assessee Union from the UNICEF free of charge is not deductible in computation of total income. Question No.3 is therefore, answered in the negative in favour of the assessee and against the Revenue. The reference stands disposed of accordingly with no order as to costs.

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